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Panel on Economic Development

**Minutes of the special meeting
held on Tuesday, 8 January 2008, at 4:30 pm
in the Chamber of the Legislative Council Building**

- Members present** : Hon Jeffrey LAM Kin-fung, SBS, JP (Chairman)
Hon Abraham SHEK Lai-him, SBS, JP (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Ir Dr Hon Raymond HO Chung-tai, SBS, S.B.St.J., JP
Hon Fred LI Wah-ming, JP
Hon CHAN Kam-lam, SBS, JP
Hon SIN Chung-kai, SBS, JP
Hon Howard YOUNG, SBS, JP
Hon Miriam LAU Kin-ye, GBS, JP
Hon Vincent FANG Kang, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon WONG Ting-kwong, BBS
Hon Ronny TONG Ka-wah, SC
Hon CHIM Pui-chung
Hon TAM Heung-man
- Members attending** : Hon Mrs Selina CHOW LIANG Shuk-ye, GBS, JP
Hon Emily LAU Wai-hing, JP
Hon WONG Kwok-hing, MH
Hon LEE Wing-tat
Dr Hon KWOK Ka-ki
- Members absent** : Dr Hon David LI Kwok-po, GBM, GBS, JP
Dr Hon LUI Ming-wah, SBS, JP
Hon LAU Chin-shek, JP

Hon Albert CHAN Wai-yip
Hon KWONG Chi-kin

- Public officers attending** : Mr Edward YAU Tang-wah, JP
Secretary for the Environment
- Mr Roy TANG Yun-kwong, JP
Deputy Secretary for the Environment
- Ms Brenda CHENG
Principal Assistant Secretary for the Environment
(Financial Monitoring)
- Attendance by invitation** : The Hongkong Electric Holdings Limited
- Mr K S TSO
Group Managing Director
- Mr C T WAN
Director & General Manager (Corporate Development)
- CLP Power Hong Kong Limited
- Mrs Betty YUEN
Managing Director
- Mr S H CHAN
Planning Director
- Mr T K CHIANG
Regulatory Strategy Manager
- Clerk in attendance** : Ms Connie SZETO
Chief Council Secretary (1)6
- Staff in attendance** : Ms Debbie YAU
Senior Council Secretary (1)1
- Ms Michelle NIEN
Legislative Assistant (1)9

- I New Scheme of Control Agreements with the two power companies**
(LC Paper No. CB(1)546/07-08(01) - Information paper on new Scheme of Control Agreements with the two power companies provided by the Administration)

Meeting arrangements

Mr Fred LI expressed concern about arrangements for the meeting. He pointed out that there were occasions in the past that the Administration had briefed the relevant Panels on important matters of wide public concern before public announcements relating to such matters were made by the Administration. He recalled that the practice was followed when the Administration briefed the Panel on matters relating to the future development of the electricity market in Hong Kong in recent years. He questioned why the Administration had made the public announcement on the new Scheme of Control Agreements (SCAs) with the two power companies on the day before without briefing the Panel first.

2. Upon invitation by the Chairman, the Clerk advised that the Administration had briefed the Panel on the Stage I and Stage II public consultation on the future development of the electricity market in Hong Kong in 2005 and 2006 respectively. As regards urgent briefings by the Administration on important matters of wide public concern, there were both occasions that the Administration had held the briefings for the relevant Panels before and after making the public announcements.

3. At the invitation of the Chairman, the Secretary for the Environment (SEN) explained that at the meeting of the Executive Council held on 7 January 2008, the Council advised and the Chief Executive ordered that the Government should sign the new SCAs with the two power companies. The Government and the two power companies entered into new SCAs on the same day. As the two power companies were listed companies in Hong Kong, the Administration could only make public announcement on the matter and inform the Panel Chairman after the close of the stock market on 7 January 2008. SEN added that he had requested the Panel Chairman to convene a special meeting at the earliest possible time for the Administration and the two power companies to brief members on the new SCAs and related matters. He apologized for giving such short notice for the special meeting.

Briefing by the Administration

4. SEN highlighted that the key terms of the new SCAs fully met the public expectation expressed during the two rounds of consultation held in 2005 and 2006. The terms also reflected the Government's policy objectives of reducing tariff and emission, and paving the way for open market. SEN summarized the key terms of the new SCAs as follows:

- (a) Under the new agreements, the permitted rate of return of the two power companies would be reduced from the existing 13.5%-15% on Average Net Fixed Assets (ANFA) down to 9.99% on ANFA. Based on the available 2006 figures, the total reduction in electricity payments for residential and commercial customers could amount to \$5 billion annually. Customers of CLP Power Hong Kong Limited (CLP) and Hongkong Electric Company Limited (HEC) could start to enjoy tariff reduction from 1 October 2008 and 1 January 2009 respectively and the extent of reduction in basic tariff (excluding fuel cost adjustment) should reach a double-digit percentage. The actual amount of tariff reduction would depend on the updated figures including ANFA and operating costs of the two companies on the commencement of the new agreements;
- (b) On emission reduction, if the power companies exceeded the emission cap for any of the pollutants specified in their Specified Process Licences (SPLs) by the Environmental Protection Department, their permitted rate of return would be reduced by 0.2 to 0.4 percentage point depending on their actual emission levels. Based on their respective ANFA in 2006, the maximum penalty for the two companies amounted to around \$200 million to \$300 million. This was a rather tough requirement and penalty. As a corollary, if their emissions for all the pollutants were below the specified caps, the companies would be entitled to an award of 0.05 to 0.1 percentage point in the permitted rate of return as an incentive. The incentive and penalty arrangements were aimed to encourage the power companies to take proactive steps to reduce emission and sustain strict compliance with environmental requirements, striking a balance between the environmental obligations of the power companies towards air quality, as well as providing them with a stable operating environment;
- (c) On the preparation for introducing competition to the electricity market, the duration of the new agreements would be reduced from the existing 15 years to ten years. The Government would take into account the market readiness for open market in deciding whether to extend the agreements for another five years. To pave the way for introducing competition to the market, the Administration would make necessary preparation in the next regulatory period, including carrying out studies on open market models and the regulatory framework as well as enhanced interconnection between the grids of the two power companies; and
- (d) With the third term of the Hong Kong Special Administrative Region Government placing environment high on its policy agenda, the new agreements had put in place provisions to support the power companies to implement more environmentally friendly measures.

For example, the power companies would enjoy a higher permitted rate of return, i.e. 11%, for their investment in renewable energy (RE) facilities. They would also be offered a bonus in the range of 0.01 to 0.05 percentage point in permitted rate of return depending on the extent of RE usage in their electricity generation.

5. SEN stressed that the conclusion of the new SCAs did not mean that the job at hand had been completed. Instead, the Environment Bureau (ENB) would continue to play its monitoring role including critically examining the capital investments of power companies to ensure room for lowering electricity tariff after the reduction in the permitted rate of return, and conducting studies and making preparations with regard to the opening of the electricity market. SEN further remarked that reaching consensus on the new SCAs was not an easy task as discussion with the two power companies involved very complicated and tough negotiation and it was necessary to balance the interests of various stakeholders. While the public aspiration was to lower electricity tariff, the Administration needed to provide the power companies with a reasonable return on their investment enabling them to continue providing reliable, safe and efficient electricity supply at reasonable prices. Moreover, ENB needed to achieve both objectives of the energy policy and the environmental protection policy at the same time. Power companies were obliged under the new SCAs to give new commitments in the area of environmental protection. SEN expressed his gratitude to all Legislative Council (LegCo) Members for their views and support provided before and during the negotiation with the power companies. He said that the Administration had taken on board Members' views where appropriate.

Briefing by Hongkong Electric Holdings Limited

6. At the invitation of the Chairman, Mr K S TSO, Group Managing Director of Hongkong Electric Holdings Limited (HEH) said that the new agreements had removed the uncertainties surrounding the electricity industry in Hong Kong over the past few years. HEC considered that its new agreement with the Government had effectively balanced customers' interests of maintaining reliable and quality electricity supply services at reasonable prices while providing HEC's shareholders with the benefits of certainty and stability of a long term regulatory framework. It also provided a more comprehensive regulatory framework which encouraged higher service standards, improved environmental performance, and promoted the use of RE. In support for the Government's clean air objective, HEC would strive to meet the emission caps to be stipulated in SPLs. On the community's aspiration for lower tariff, Mr TSO said that there were two components in HEC's tariff, viz, basic tariff and Fuel Clause Surcharge. While agreeing that lowering the permitted rate of return could help lower the basic tariff and the reduction could probably reach a double-digit percentage, due to the volatility of fuel prices, it was impossible to forecast the tariff level for 2009 at the present stage. HEC would discuss with ENB in details the possible extent of tariff reduction for 2009 after obtaining more realistic data. Mr TSO undertook that under the new agreement, HEC would continue to provide safe, efficient and reliable electricity supply at

reasonable prices to its customers, while continuing to improve the environment and contributing to the prosperity of Hong Kong.

Briefing by CLP Power Hong Kong Limited

7. Mrs Betty YUEN, Managing Director of CLP welcomed the new SCA concluded with the Government, which provided a clear regulatory framework for CLP to continue investment and operation in providing quality electricity services to its customers. She stressed that during the negotiation with the Government, CLP had made strenuous efforts in meeting the key principles set out by the Government, namely, reducing the permitted rate of return, linking environmental performance to return and paving the way for introducing competition. Mrs YUEN stressed that CLP would strive to achieve the common objective of the Government and the power companies in allowing the Hong Kong community to enjoy electricity services of world-class standard at reasonable tariff, and that CLP would strive to meet the increasing expectation of the public on environmental protection. On the possible extent of reduction in basic tariff, Mrs YUEN said that CLP would endeavour to enable its customers to enjoy a lower basic tariff, and she was confident that there would be room for the reduction of its basic tariff. CLP would submit the relevant data for the review of the Government within the next few months.

Discussion

Permitted rate of return for the power companies and tariff reduction for customers

8. Miss TAM Heung-man criticized that the permitted rate of return of 9.99% was "a game of numbers" between the Administration and the power companies, as the percentage was near to one with double-digit. She considered that the Government had failed to safeguard the interests of consumers in the negotiation. In anticipation of rising volatility in the international fuel prices and the onset of inflation in Hong Kong, Miss TAM expressed grave concern that even with the reduction of permitted rate of return in the new SCAs, the benefit of tariff reduction to consumers would be quickly eroded. She asked whether the Administration had assessed the impacts of fuel prices and inflation on the extent of tariff reduction.

9. Dr KWOK Ka-ki expressed disappointment on the new permitted rate of return of 9.99%, which he considered was just cosmetic. He remarked that it could be the reason for the two power companies to express satisfaction over the new SCAs.

10. SEN stressed that during negotiation with the power companies, the Administration had always borne in mind the interests and aspiration of the public, which included, reducing the permitted rate of return to a single-digit percentage and tightening emissions from power generation. As regards the possible extent of tariff reduction, SEN said that while the fluctuation in international fuel prices

might affect the fuel costs of the power companies, they had already undertaken to bring down the basic tariffs in the first year of the new SCAs. He re-iterated that based on the available 2006 figures, the total reduction in electricity payments could amount to \$5 billion annually.

11. Mrs Betty YUEN highlighted that substantial increase in the international fuel prices had created increasing pressure on CLP's production cost. Nevertheless, CLP was able to secure contracts for quality supply of fuel at reasonable prices due to the good relationship maintained with fuel suppliers.

12. Mr CHIM Pui-chung considered that lowering the permitted rate of return from 13.5%-15% to 9.99% in the new SCAs should translate into reduction in tariff up to 30% to 50%. Pointing out that fuel cost only represented part of the operating costs of the power companies, he stressed the need for the Administration to closely monitor the Development Plans of the companies to ensure their capital investments were related to electricity businesses in Hong Kong so as to prevent cross subsidies by local consumers for other markets.

13. SEN responded that percentage reduction in the permitted rate of return would not be matched with tariff reduction to the same extent as tariff level was set to recover various cost elements such as operating expenses, depreciation charges and fuel costs, in addition to the permitted return on ANFA. He said that the Fuel Clause Surcharge levied by the power companies was dependent on the actual prices of the fuel supply. Moreover, as listed companies, the two power companies were required to disclose their assets in relation to electricity businesses, and details of investments in the Mainland and overseas markets, if any.

14. While commending the Administration's efforts in entering into the new SCAs with the power companies, Mr WONG Kwok-hing opined that there was no room for complacency. He urged the Administration to continue monitoring the power companies closely to prevent them from engaging in financial maneuverings for gaining a permitted rate of return higher than 9.99%.

15. SEN said that the conclusion of the new SCAs signified the commencement of work for a new stage for ENB. He highlighted that the new agreements would address public concern about the need to enhance protection for the environment, and cater for studies and preparations with regard to the opening up of the electricity market. Moreover, he fully recognized the public expectation for lowering electricity tariff and for the Administration to critically examine the Development Plans and capital investments of the power companies. On the concern about the possibility for power companies to gain a permitted rate of return above 9.99%, SEN explained that the incentive and penalty arrangements under the new agreements were aimed to encourage the power companies to take proactive steps to improve their operating and environmental performance. He said that the penalties altogether could bring down the permitted rate of return to as low as 9.56%. If the power companies succeed in lowering emissions to below the specified caps in SPLs, they would be entitled to an award in the permitted rate of

return. He believed that the public would be willing to pay for enhancement in the companies' emission performance.

16. Mr Andrew LEUNG said that the Liberal Party (LP) had urged the Government to lower the permitted rate of return in the new SCAs to 7% or below in view of the low cost of living in Hong Kong in the past few years. LP considered the permitted rate of return of 9.99% in the new SCAs reasonable, since those in overseas markets were up to 12% in recent years. He considered that the win-win situation in the new SCAs was achieved with the efforts of the Government and co-operation of the power companies. However, in view of the upward adjustment in tariff in 2008 mainly resulted from surge in fuel costs and the onset of inflation, the public had stressed the need for the Administration to strengthen monitoring over the power companies, to ensure that the estimated reduction in electricity payments amounting to \$5 billion annually could materialize.

17. On the possible extent of tariff reduction upon commencement of the new SCAs, SEN assured members that while the power companies were not in the position to confirm the new tariff levels at this stage, they had no strong objection to the Government's forecast of a double-digit percentage reduction in basic tariff, which was made on the basis of the available 2006 figures. In fact, the same prediction had also been made by some academics and economists. Moreover, to limit the room for the power companies to adjust their tariffs, SEN said that under the new SCAs, the threshold requiring Government's approval for tariff adjustment in excess of the projected basic tariff level previously approved by the Executive Council in the context of Development Plan was reduced from the current 7% to 5%.

18. Mr WONG Kwok-hing asked when the power companies would announce the new tariff levels. Mr K S TSO said that the new tariff level of HEC under the new SCA would mainly depend on changes in fuel cost, the details of which would be worked out after the contracts for supply of fuels in 2009 had been finalized. He re-iterated that when more realistic data were available, HEC would discuss with ENB in details the possible extent of tariff reduction in 2009. Mrs Betty YUEN said that CLP had to work under a tight schedule as its new SCA would take effect from 1 October 2008. CLP would submit the relevant data for review by the Government within the next few months.

19. Noting that the tariff of HEC was some 30% higher than that of CLP, Mr WONG Kwok-hing enquired about the reasons and whether SEN had sought to narrow the gap during the negotiation for the new SCAs in consideration that the huge difference in tariff was unfair to customers of HEC. He also urged HEC, as a responsible social corporation, to consider reducing its tariff.

20. Acknowledging the concern, SEN pointed out that the tariffs charged by the two power companies had reflected the different capital investments and operating costs of the companies as they served different geographical markets in

Hong Kong. He assured members that ENB would continue to play its monitoring role effectively to guard against over-investment by the power companies.

21. Mr K S TSO responded that the different tariffs between HEC and CLP mainly resulted from different capital investments and sources of revenue of the two companies. He explained that as HEC's generation facilities were located on Lamma Island, electricity was supplied to its customers on the Hong Kong Island through submarine cables. Therefore, unlike the transmission network of CLP which mainly comprised overhead lines, the construction and operating costs of the transmission network of HEC were relatively higher. Moreover, about 75% of HEC's customers were commercial clients while CLP had a better customer mix. In addition, due to larger geographical coverage of CLP's service area, CLP could sell more electricity than HEC.

Capital investments by and Average Net Fixed Assets of the two power companies

22. Miss TAM Heung-man re-iterated her concern about using ANFA as the basis for determining the permitted return as the method was perceived to have encouraged over-investment by the power companies. She further urged the Administration to exercise effective control over the capital investments of the two power companies, and sought details on the relevant measures to be taken in this regard. In this connection, Dr KWOK Ka-ki expressed concern that CLP's proposal to construct the \$10.2 billion Liquefied Natural Gas (LNG) Receiving Terminal (the LNG terminal) was an attempt to enlarge its ANFA in order to reap more profits.

23. SEN assured members that ENB would continue to actively monitor and critically examine capital investments of the power companies to meet public expectation. The Deputy Secretary for the Environment (DS/EN) elaborated the details of the control mechanism and pointed out that in line with arrangements in the existing SCAs, the power companies were required to submit to the Administration their five-year Development Plans which included forecast of the future electricity demand, the need for additional generating capacities and other capital investments, the impact on tariff, etc. In reviewing the plans, the Administration would assess whether the need and cost for additional assets were justified. As regards the concern about the asset base approach in the regulatory regime, DS/EN said that many overseas electricity markets had also adopted the fixed asset approach using ANFA as the base for determining returns to power companies.

24. On the concern about the LNG terminal, SEN clarified that while CLP had obtained the Environmental Permit for the construction of the terminal which only concerned the environmental acceptability of the project, the Government was still reviewing the proposal in conjunction with an energy consultant. The review covered all relevant factors including the need for the facility, its financial impact, the distribution and development of natural gas in the region, and other planning

issues. He assured members that the Administration would exercise due diligence in examining capital investments proposed by the power companies.

25. Mr Ronny TONG considered that the assets to be covered in the rate base and the calculation of ANFA should be reviewed and enquired whether the Administration would consider making adjustments in these areas if the new SCAs were to be extended for five years to 2023. SEN said that the new SCAs had been shortened from 15 to ten years, with an option exercisable by the Government to extend for five more years, after a review of the prevailing market conditions including whether new supply sources were available. However, during the extended period, CLP and HEC would be allowed to earn the same permitted rate of return on their ANFA (including those incurred or invested in the eleventh year to the fifteenth year if approved by the Government).

26. Mr CHIM Pui-chung expressed grave concern on the need for the Government and the power companies to enhance disclosure of information on the levels of ANFA of the two power companies, so as to facilitate public monitoring of the capital investments of the power companies. SEN stressed that in the financial monitoring of the power companies, the Government would continue to examine the Development Plans of the companies, to ensure that the additional capital investments were necessary and the costs were reasonable.

27. Noting that the asset depreciation period for certain assets of the power companies would be extended in the new SCAs, Mr Fred LI sought justification for the proposal and expressed concern about whether the power companies would gain additional benefits as a result. Mr Andrew LEUNG shared the same concern.

28. DS/EN said that the above changes were related to accounting control of the new SCAs. According to the Electrical and Mechanical Services Department and its independent consultant, the extension of the asset depreciation period for certain assets to better reflect their useful lives was reasonable. The proposed accounting treatments to reflect the changes were in line with the Hong Kong Accounting Standard. He stressed that the changes could help extend the useful lives of fixed assets of the power companies and thereby deferring the need for investing in new assets. Moreover, the provision for asset decommissioning obligation would not increase the fixed asset values and thus would not attract permitted return.

Mechanism for treatment of excess generating capacity

29. Dr KWOK Ka-ki referred to paragraph 17 of the Administration's paper and sought explanation on the rationale for raising CLP's excess capacity from 40% to 50%. DS/EN clarified that under the existing SCAs, 40% and 50% of the net asset value on machinery and electrical equipment relating to new generating facility (the new facility) found to be excessive upon commissioning to meet the latest electricity demand would be excluded from ANFA of CLP and HEC respectively in the calculation of permitted returns for the companies. It was

agreed that under the new SCAs, the deduction from ANFA in relation to excess capacity would be increased from 40% to 50% of the new facility for CLP while that for HEC would remain the same. The revision was to align the treatment on excess generating capacity of the two power companies.

30. Mr CHAN Kam-lam said that Members of the Democratic Alliance for the Betterment and Progress of Hong Kong welcomed the new SCAs. He sought information on the level of excess generating capacity allowed for the power companies. DS/EN said that the Administration did not set such a level as the power companies were discouraged from investing in excess generating capacity.

31. Mr LEE Wing-tat considered that the mechanism for treatment of excess generating capacity unfair to customers, as they were held responsible for mistakes in the forecast of generating capacity made by the power companies. SEN re-iterated that ENB would continue to prudently examine the Development Plans of the power companies. He remarked that the mechanism for treatment of excess generating capacity was reasonable. If the mechanism were to exclude a larger portion of the net asset value, it might discourage the power companies to make the necessary new investment.

32. Mr LEE Wing-tat was unconvinced by the Administration's explanation. He considered that as the investment was made based on the power companies' own assessment, the companies should bear a larger portion of the responsibility. Mr C T WAN, Director & General Manager (Corporate Development) of HEH remarked that the penalty mechanism for excess generating capacity for HEC and CLP was unique among the power sectors in the world. Indeed, the mechanism had put great pressure on HEC in making forecast in generating capacity in meeting future electricity demand, since there would normally be a three to four years' gap between the forecast and the commissioning of the new generating facility. Given that excess generating capacity would be subject to penalty, HEC would be extremely cautious in making the forecast and investment decisions while ensuring that customers could continue to enjoy a reliable and stable electricity supply.

Emission performance linkage mechanism and use of renewable energy in power generation

33. Dr KWOK Ka-ki said that according to reports by international media, CLP's power plant in Castle Peak Power Station was among the bottom three rankings in the world in respect of emission performance of carbon dioxide, and the emission performance of HEC was also below average. As such, he did not consider it appropriate to use the existing emission performance of the two power companies as the basis for setting the emission caps to be achieved under the new SCAs.

34. SEN stressed that the Administration had spared no effort in tightening the emission standards of the power plants in the past few years, and would continue to strengthen its work. For instance, to meet the bilateral agreement between Hong

Kong and Guangdong Province in improving the regional air quality, the emission cap for sulphur dioxide for CLP's power plants would be lowered from 50 500 tonnes in 2006 to 16 000 tonnes by 2010, while that for HEC's power plants would be reduced from 29 500 tonnes in 2007 to 9 500 tonnes by 2010. Under the new SCAs, the permitted rate of return of the power companies would be linked to their emission performance. The Administration had agreed with the power companies a penalty level of 0.4 and 0.2 percentage point reduction of return on all non-RE fixed assets for exceeding any of the emission caps by $\geq 30\%$ and $\geq 10\%$ respectively. In monetary terms, they were equivalent to a maximum penalty of \$290 million and \$186 million for CLP and HEC respectively, based on 2006 figures.

35. Ir Dr Raymond HO was pleased to note that instead of resorting to a high-handed approach of regulating the electricity market through legislation as indicated by the Administration in late 2007, the Government had entered into the new SCAs with the power companies. He considered that the new SCAs had recognized the contribution made by the power companies in providing reliable and stable power supply services in Hong Kong, and struck a proper balance between the interests of the power companies and consumers. On the incentive and penalty arrangements to encourage the power companies to improve their environmental performance, Ir Dr HO considered that the financial incentive for the power companies to increase the usage of RE in power generation was not adequate in consideration of the high investment cost of RE facilities. In particular, it was unreasonable for the penalty levels under the emission performance linkage mechanism to be much higher than the incentive levels. Ir Dr HO further expressed concern about the methodology to be adopted in working out the emission caps for power plants, in particular the types of pollutants to be covered and the period during which the emission levels would be taken.

36. SEN said that during the Stage I and Stage II public consultation on the future development of the electricity market, the public had in general expressed support for enhanced usage of RE in electricity generation in Hong Kong. In meeting the target of having 1% to 2% of local power needs met by RE by 2012, incentives were provided in the new SCAs for more usage of RE whereby the power companies could enjoy a rate of return of 11% for investments in RE facilities. Additional increase in rate of return for electricity generation by RE could be up to 0.05 percentage point if electricity so generated accounted for 5% or more of the total production in electricity. SEN further said that in addition to tightening the emission caps gradually in SPLs of the power plants, the Administration also sought to cap the maximum emission on major types of pollutant allowed for the power sector in 2010 and beyond under the Air Pollution Control (Amendment) Bill 2008, to enable the companies to enter into emission trading with the power plants in Guangdong Province. As the emission caps would be tightened and renewed from time to time, the linkage mechanism would apply annually from 1 January 2009 onwards. If the power companies exceeded the emission cap for any of the pollutants imposed under the Air Pollution Control Ordinance (Cap. 311), their rates of return would be reduced from 0.2 to 0.4

percentage point.

37. Mr CHAN Kam-lam noticed that investments in RE facilities would be counted towards ANFA, and financial incentive in the form of additional return would also be provided with increase in the percentage of electricity so generated. Given that the mechanism for treatment of excess generating capacity would not apply to RE assets, he was worried that the power companies might be able to enlarge their asset base by increasing investment in RE facilities. SEN confirmed that investment in RE facilities, like other electricity supply infrastructure of the power companies, required Government's approval. DS/EN added that although RE facilities would be counted as fixed assets of the power companies, given the uncertainty on the supply sources of RE and its zero emission performance, it would be unfair to apply the penalty mechanism for treating excess generating capacity to RE facilities. Upon the Administration's further clarification that the reserve margin of generating capacity of the power companies would not be considered as excess generating capacity, Mr CHAN requested that the respective levels of reserve margin and excess generating capacity of the power companies, as well as information on their ANFA, should be disclosed to facilitate public monitoring.

Tariff Stabilization Fund

38. In reply to Mr Fred LI's enquiry about the disposal of CLP's Development Fund (DF) upon the expiry of the current SCA, Mrs Betty YUEN advised that the balance in DF as at 30 September 2008 would be transferred to the new Tariff Stabilization Fund (TSF). In line with the existing practice, the funds in TSF would be used to ameliorate the impact of tariff increase for consumers.

39. In reply to Ms Emily LAU's enquiry about the regulation on CLP's electricity sale to the Mainland under the new SCA, DS/EN advised that under the new agreement, CLP was required to continue to transfer 80% of the profit generated from the electricity sale to TSF to provide benefits for local customers. He drew members' attention that in terms of environmental impacts, power generated by CLP would be much cleaner than that generated by suppliers in Guangdong, and hence the electricity sale would help improve the regional air quality.

Introducing competition to the electricity market

40. Mr SIN Chung-kai commended the work of SEN in achieving a single-digit return of 9.99% in the new SCAs. Noting that the new agreements would be shortened to ten years in preparation for the opening of the electricity market, he sought information on the implementation schedule. Given the lead time for construction of electricity infrastructure, he considered that if the Administration's intention was to introduce new supply sources by 2018, potential new players would need to commence planning within the next four to five years. In this connection, Mr CHIM Pui-chung expressed support for fair competition in the

electricity market and echoed the need for the Administration to make early preparations for the opening of the market.

41. Regarding the opening of the electricity market in Hong Kong, SEN said that there had been thorough public discussion on the subject during the Stage II consultation. While there was public support for the Government in moving towards this direction, concerns had been raised about the availability of new supply sources in the region, and whether the issues of high tariff and rates of return to the power companies could be resolved by introducing more competition in the market. While taking note of these concerns, the Government had made preparation for opening the market by shortening the duration of the new SCAs to ten years, with an option exercisable by the Government to extend for five more years. If the Government decided to make changes to the electricity regulatory framework by 2018 upon the expiry of the new SCAs, the Administration would notify the power companies by 2016.

42. Mr SIN Chung-kai expressed disappointment that the community had to wait until 2016 until a firm decision on whether to introduce new supply sources by 2018 could be made. SEN said that introducing competition to the electricity market in 2018 would depend on whether the requisite market conditions were present, and stressed that a number of issues needed to be addressed in making arrangements to cater for new supply sources. For example, whether a small place like Hong Kong could generate sufficient market for additional power suppliers, especially when CLP was already selling surplus electricity to Guangdong Province. Moreover, matters relating to access to the existing power grids, increased interconnection among suppliers and the future regulatory framework should be carefully examined and thoroughly deliberated within the duration of the new SCAs.

43. Mr Fred LI stressed the need for the Administration to draw up a clear roadmap for opening the electricity market and take swift actions within the next ten years. For instance, the Administration should devise concrete plans to establish an appropriate regulatory framework allowing grid access by new suppliers in the long run. Mr Ronny TONG also opined that the Administration should work out the implementation timetable with concrete measures and targets, including making arrangements to facilitate the separation of electricity generation from transmission and distribution services.

44. SEN confirmed that it was the Government's stated intention to introduce competition to the electricity market in as early as 2018. Government would discuss with the power companies before 1 January 2016 about the market readiness, potential changes to the electricity regulatory framework and transition issues. While acknowledging the concerns about grid access and the separation of electricity generation from transmission and distribution services, SEN said that it was impossible for him to reach an agreement with the power companies on the matters within six months after he had taken up the present post as complicated issues were involved. He stressed that the existing power grids were assets of the

two power companies. It was necessary for the Government to study the matters thoroughly in working out a suitable mechanism to allow grid access.

45. Ms Emily LAU asked whether the discussion on potential changes to the electricity regulatory framework after 2018 could commence earlier. Mr LEE Wing-tat echoed the view and considered that sufficient time should be allowed for public discussion and preparation of the relevant legislation. In this connection, he suggested that the Administration should update the Panel on the progress at regular intervals. Taking note of members' concern, SEN considered that to facilitate preparation by CLP, HEC, and potential new suppliers for the opening of the electricity market, it was appropriate for the Government to notify the two power companies of any proposed changes to the electricity regulatory framework prior to January 2016, i.e. two years before the expiry of the new SCAs.

Stranded costs for the power companies

46. The Chairman enquired about the reasons for including a term on stranded costs in the new SCAs and sought information on the details. SEN advised that the term was made in preparation for the introduction of competition to the electricity market. He elaborated that the provision of the term was in line with international practices whereby when overseas electricity markets were opened up, a mechanism was devised to allow power companies to recoup the costs for the assets that became stranded. In the event of a change implemented by the Government to the electricity supply market structure which caused material impact to the power companies, they could recover from the market stranded costs that could not be mitigated by measures required by the Government. The amount of stranded costs that could be recovered from the market and the recovery mechanism were to be agreed between the Government and the power companies. Parties might seek to resolve issues through arbitration. In response to the Chairman's further enquiry, SEN said that negotiation for extension of the new SCAs and discussion on the stranded costs and the related coverage mechanism were separate matters.

The need for further consultation

47. Ms Emily LAU referred to the motion on opening up the electricity market passed at the LegCo meeting on 15 February 2006, which urged the Government to, inter alia, earnestly improve the current phenomenon of natural monopoly in the electricity market in Hong Kong, re-set electricity tariffs at a reasonable level by lowering the permitted rate of return to 7% or below on ANFA, formulate practicable measures to ensure that the power companies actively develop renewable energy, set a timetable for opening up the electricity market in Hong Kong and aim for its implementation in the coming ten years, and actively study the full implementation of power interconnection. Ms LAU was disappointed to note that despite having the full support of LegCo, SEN could only achieve in the new SCAs a permitted rate of return of 9.99%. She also expressed grave concern about the power companies' remark that it was too early to conclude at the present

stage that there would be a double-digit percentage reduction in the basic tariff.

48. Referring to the Administration's response to the motion, SEN recapitulated that meeting the Government's energy policy objectives involved striking a balance between the interests of the public and the power companies. On seeking to lessen the burden of tariffs on the public, the power companies should at the same time be allowed to make a reasonable return, thus providing them with incentives to continue making investments in necessary electricity supply infrastructure and providing quality services to the public. While the Government's original proposal on the permitted rate of return was in the range of 7% to 11%, the rate of 9.99% in the new SCAs had conformed to the bottom line of a single-digit return as stated by the Government on various occasions. On other fronts, SEN stressed that the new SCAs also met public expectation in respect of environmental performance and introduction of competition to the electricity market.

49. Ms LAU suggested that the Panel should consider conducting public hearings to gauge public views on the new SCAs. The Chairman said that he would consult members on the suggestion at the next Panel meeting.

(Post-meeting note: At the regular meeting held on 28 January 2008, members agreed that the Panel would not hold public hearings for the above purpose.)

II Any other business

50. There being no other business, the meeting ended at 6:30 pm.